United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

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P/S

74-1023

United States Court of Appeals

FOR THE SECOND CIRCUIT

1050 TENANTS CORP., HERBERT SALTZMAN and JOAN SALTZMAN,

Plaintiffs-Appellees,

—against—

PETER JAKOBSON, JOHN R. JAKOBSON, ARTHUR D. EMIL and LAWRENCE A. KOBRIN,

Defendants-Appellants.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF PLAINTIFFS-APPELLEES

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Preliminary

The District Court (Stewart, *J.*), in a soundly reasoned opinion, correctly held that the shares of stock of 1050 Tenants Corp. which defendants publicly sold constituted "securities" within the meaning of the federal securities laws because: (a) the definitions of the term "security" in the statutes expressly include "any . . . stock"; and further (b) what defendants sold were "investment contracts" which are also expressly included in the statutory definitions of "security." Judge Stewart correctly emphasized that the federal securities laws are intended to be applied and construed liberally for the protection of investors, not restrictively so as to provide loopholes by which defraud-

ing sellers may escape liability to their victims. The opinion of the District Court is reported at 365 F. Supp. 1171 (S.D.N.Y. 1973).

The decision of the District Court comports with the express language of the federal securities laws, the applicable case law and the liberal public policy which the Courts have consistently recognized underlies those statutes, and should be affirmed.

The Issue—Properly Stated

Defendants have neither correctly nor fairly stated the issue for review. The issue was correctly stated by Judge Stewart in his opinion below (365 F. Supp. at 1171):

> "are the shares of the plaintiff Corporation 'securities' under the federal securities laws?"

The Relevant Facts

Defendants have persisted in misdescribing this case as one involving the sale of "real estate," and in ignoring the fact that defendants sold and promoted the sale of shares of stock in a business corporation. Defendants have concentrated virtually their entire brief on a contorted and unduly abbreviated reading of the cooperative plan, which suppresses the essential facts of the transaction.

The record shows, as Judge Stewart recognized, that under the cooperative plan which defendants sponsored, the individual plaintiffs purchased stock in 1050 Tenants Corp. (38a, 89a, 93a, 109a).* Indeed, the purchase agreement which each purchaser actually signed (Exh. G) stated:

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* Numbers followed by "a" in parentheses refer to pages in the printed Appendix, filed by appellants.

"1. The Purchaser agrees to purchase from the Apartment Corporation ..... shares of its capital stock, fully paid and non assessable, of $1.00 par value for a total purchase price of $ ....." (89a).

1050 Tenants Corp. is a business corporation organized under the New York Business Corporation Law (47a), with stockholders and a Board of Directors just like any other business corporation.* Each share of stock entitles its owner to one vote at shareholders' meetings (47a) and when issued is fully paid and non-assessable (47a). Directors are "elected by the shareholders on the basis of one vote for each share of stock" owned (48a).

Each year, the shareholders are entitled to receive an annual report from the corporation, certified financial statements and notice of the annual meeting of stockholders (62a-63a), just like stockholders in any other business corporation. The corporation also has by-laws, directors' meetings and stock certificates, the same as any other business corporation (101a).

The corporation, not the stockholders, owns the real estate to which defendants' brief continually refers (38a), and thus is in essence merely a real estate holding corporation. Under the Plan, all that the shareholders own is stock in the corporation (38a). The Plan states this relationship quite clearly (38a):

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* Defendants have attempted, through a series of footnotes addressed to tangential matters, to place before the Court alleged facts and assumptions of fact which have no support in the record or in judicial or other authority and which make unwarranted claims as to what purchasers and others intend or in the past intended. These unsupported discussions should be disregarded as outside the scope of the record and this appeal.

> "Under the Plan, *the Apartment Corporation will acquire full title to the Property, and individuals who purchase shares of stock* in the Apartment Corporation which are allotted to the apartments under the Plan *will be shareholders of the Apartment Corporation . . .*" (emphasis added).

The sale of the stock was central, not merely an incidental transaction under the Plan. Even the effectiveness of the Plan itself was linked directly to the sale of the stock (61a):

> "the Plan will be declared effective . . . if, within eight months or less from the date of its presentation, at least 80% of the shares in the Apartment Corporation have been sold under executed Purchase Agreements . . ."

Defendants have sought to divert attention from these seminal facts by a series of unfortunate misstatements about the operation of the corporation and the provisions of the proprietary leases.

For example, defendants incorrectly assert (Br., p. 5):

> "Under the Plan, individual tenant-owners were to own their apartments under proprietary leases with a corporate entity in which the tenant-owners were to hold 'stock.'"

This obviously misstates the entire transaction. The proprietary leases did not confer ownership to anything; as already shown, the Plan makes quite clear that the corporation, not the stockholders, owns the realty. The so-called tenant-owners bought only stock, not a lease (cf. Exh. G(1)

to the Plan, 89a). The ownership of the stock gave them the right to enter into a proprietary lease to *lease* an apartment, not vice versa. Thus, the proprietary lease provides: "The Lessor hereby leases to Lessee . . ." (114a).*

Similarly, defendants falsely claim (Br., p. 5) that the corporation "could not conduct any other business" than "ownership on a cooperative basis of the building" and that "no dividends or other benefits could be paid to the shareholders of the corporation." This is not so. The plan contains no such statement, and the record cites listed by defendants do *not* so provide. Indeed, the Plan expressly confirmed that 1050 Tenants Corp. would be obtaining "income" from operations, such as the renting of doctors offices and operation of laundry machines, all of which is applied to offset the maintenance costs of the individual stockholders (40a). The certificate of incorporation is not part of the record, but, in actual fact, it contains no such limitation. Among other things, as just noted, the corporation rents out four doctors offices, the rental income from which the Plan calls "commercial or professional income" (40a). This income alone was projected in the prospectus to be $24,500.00 annually (80a). Regardless, however, 1050 Tenants Corp. is a business corporation and, as such, is expressly empowered by the Business Corporation Law, under which it was created, to amend its certificate "to enlarge, limit or otherwise change its corporate purposes" (BCL §801(b)(2)). Similarly, the BCL

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* As one Court has aptly observed:

"It is the shares of the corporation that are sold and despite a vernacular use to the contrary, the apartment is not sold but leased under a so-called proprietary lease." *Susskind* v. *1136 Tenants Corp.*, 43 Misc. 2d 588, 590 (Civ. Ct. N.Y. Co. 1964).

specifically authorizes the payment of dividends (BCL §510).

Likewise, the fact that the stock is subject to restrictions is irrelevant and surely does not deprive it of its status as "stock." Stock in business corporations is often sold subject to restrictions on transferability in corporate buy-sell agreements, shareholders agreements, letters of investment intent, etc. Those restrictions do not alter the rights of the stockholders to participate in the corporation's management and to share in a proportionate share of its assets in the event of dissolution or otherwise to enjoy the usual rights of corporate stockholders.*

The Decision Below

Judge Stewart carefully considered and rejected each of defendants' arguments and upheld federal subject matter jurisdiction under the federal securities laws (365 F. Supp. 1171).

1. Judge Stewart first held that the stock of 1050 Tenants Corp. falls within the phrase "any . . . stock" which is specifically included in the definition of "security" in the federal securities laws. In reaching that conclusion, Judge Stewart recognized that the applicable case law and legislative history all support a broad interpretation of the phrase "any . . . stock" in a situation such as that at bar—i.e., where stock certificates have actually been issued "within a traditional corporate structure" (365 F. Supp. at 1173-74).

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* Cf. *Stockton* v. *Lucas*, 482 F.2d 979 (Temp. Emerg. U. S. Ct. App. 1973); *Globe Slicing Mach. Co.* v. *Hasner*, 333 F.2d 413 (2d Cir. 1964) cert. den. 379 U.S. 969 (1965).

As Judge Stewart emphasized, 1050 Tenants "is organized under the state Business Corporation Law", and the shares of its stock "are no different than shares in other New York business corporations" (365 F. Supp. at 1175). Additionally, Judge Stewart noted that, as is still true, "defendants offer no persuasive reason why the phrase 'any . . . stock' is, or should be, read restrictively" in direct contravention of "the consistently liberal and broad interpretation given to the provisions of the federal securities laws" (365 F. Supp. at 1175).

2. Judge Stewart also held that "the corporate scheme in this case falls under the 'investment contract' provision" of the statutory definition of "security" (365 F. Supp. at 1175).

Applying the three tests of the *Howey* case to the case at bar, Judge Stewart noted that the defendants concede that the "common enterprise" element is present and that the facts satisfy the "profit" and "reliance on others" elements of the test. A sufficient expectation of profit existed in that the purchasers of the stock might be able to resell it at a substantial profit, would be receiving direct monetary tax benefits and would be receiving their proportionate shares of the income received by the corporation from the rental of professional offices (365 F. Supp. at 1176). There was also sufficient reliance on the efforts of the third-parties since the "defendant sponsors had complete control over the initial financial arrangements and the general guidelines under which the Corporation still operates," since "the Plan made provision for sponsor representation on the Board of Directors" and since "the defendant sponsors did obligate the Corporation to at least nine contracts, including one for the management of the building by an

agent of the sponsors, which extended for three years past the time the shareholders were supposedly in complete control" (365 F. Supp. at 1176-77).

Thus, although expressing no opinion on the merits,* Judge Stewart held:

> "Either because shares in plaintiff Corporation constitute stock or because they constitute investment contracts under the federal securities laws, this Court has subject matter jurisdiction . . . " (365 F. Supp. at 1177).

Plaintiffs respectfully submit that Judge Stewart was correct on both grounds. However, either ground is sufficient in itself; if this Court agrees with Judge Stewart on either ground, the decision below should be affirmed.

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* In point of fact, plaintiffs are entitled to prevail on the merits also. The District Court denied defendants' motion to stay all discovery during the pendency of their dismissal motion (2a), and extensive discovery has been conducted since the filing of the motion. As demonstrated in our papers in response to defendants' petition to this Court for certification of this appeal pursuant to 28 U.S.C. §1292(b), that discovery has yielded deposition admissions and documentary proof from defendants' own files that defendants had, but misstated or suppressed (not only from plaintiffs but from the N. Y. Attorney General), material adverse information as alleged in paragraphs 22 and 23 of the complaint (13a-16a).

POINT I

The Federal Securities Laws Should Be Liberally and Broadly Construed and Applied.

Central to any determination of the scope of the definition of "security" is the fundamental public policy underlying the antifraud provisions of the federal securities laws, namely that they are "remedial statutes [which] should be liberally construed" for the protection of investors. See, e.g., *SEC* v. *Joiner Leasing Corp.*, 320 U.S. 344, 353 (1943); *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963); *Glen-Arden Commodities, Inc.* v. *Costantino*, —— F.2d ——, Slip Sheet Opinion 817-18 at p. 2186, CCH Fed. Sec. L. Rep. ¶94,436 (2d Cir. 1974).

As the U. S. Court of Appeals for the Second Circuit (per Oakes, *J.*) stated only recently in *Glen-Arden Commodities* (Slip Sheet Opinion at p. 2186):

> "[A]s we ourselves have been repeatedly enjoined by the Supreme Court, the federal securities laws are to be construed 'not technically and restrictively, but flexibly to effectuate [their] remedial purposes' . . . [W]hat is determinative is not what is left out of the definition of a security, but rather what is included."

Judge Stewart correctly recognized and applied this policy of liberality and broad construction to the facts at bar. As Judge Stewart recognized, defendants' argument that the Court construe the plain words of the statutory definition (e.g., "any . . . stock") restrictively would unjustifiably thwart rather than effectuate that fundamental public policy.

POINT II

The Shares of Stock of 1050 Tenants Corp. Are Securities.

As Judge Stewart held, the shares of stock of 1050 Tenants Corp., which defendants sold and promoted the sale of, are "securities" within the express provisions of Section 2(1) of the Securities Act of 1933 (15 U.S.C. §77b(1)) and §3(a)(10) of the Securities Exchange Act of 1934 (15 U.S.C. §78c(a)(10)) which provide that:

> "the term 'security' means *any* note, *stock*, . . . investment contract . . . or, in general, any interest or instrument commonly known as a 'security' " (emphasis added).

Plaintiffs submit that the issuance of stock at bar by 1050 Tenants Corp., which is a business corporation falls squarely within that definition.

1. *The plain language of the statutes*

The statutory definitions expressly say "any . . . stock" and, thus, on their face include the stock of 1050 Tenants Corp. *SEC* v. *Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943); *Movielab, Inc.* v. *Berkey Photo, Inc.*, 321 F. Supp. 806, 809 (S.D.N.Y. 1970) (Mansfield, *J.*) aff'd 452 F.2d 662 (2d Cir. 1971). See also: *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 151 (1972).

As the U. S. Supreme Court (per Jackson, *J.*) stated in *Joiner, supra* (320 U.S. at 351):

> "In the Securities Act the term 'security' was defined to include by name or description many documents in

which there is common trading for speculation or investment. *Some, such as notes, bonds, and stocks are pretty much standardized and the name alone carries well settled meaning.* Others are of more variable character and were necessarily designated by more descriptive terms, such as 'transferable share,' 'investment contract,' and 'in general any interest or instrument commonly known as a security.' We cannot read out of the statute these general descriptive designations merely because more specific ones have been used to reach some kinds of documents. *Instruments may be included within any of these definitions, as matter of law, if on their face they answer to the name or description.*" (Emphasis added.)

Judge Mansfield gave broad meaning to the words "any note" in the definition of "security" in *Movielab, supra,* stating (321 F. Supp. at 808-09):

"Upon turning to § 3(a)(10) of the 1934 Act, however, we find that it provides, in unequivocal and all-embracive language, that 'The term "security" means any note . . . '. This plain language, literally read, clearly includes promissory notes of the type that are the subject of the present suit. In interpreting the statute we are guided by well recognized basic principles.

There is, of course, no more persuasive evidence of the purpose of a statute than the words by which the legislature undertook to give expression to its wishes. Often these words are sufficient in and of themselves to determine the purpose of the legislation. In such cases we have followed their plain meaning" [citation omitted].

> "Try as we may, we fail to detect in the 1934 Act any grant of discretionary power to the court to construe the term 'security' as including certain types of notes but not others. Congress apparently decided that it would pass a sweeping prohibition rather than attempt to draw such distinctions. We are bound by that decision." *

The same type of liberal construction has been applied with respect to other portions of the federal securities acts. Thus, in commenting in *Affiliated Ute Citizens, supra,* upon the language of Rule 10b-5 Mr. Justice Blackmun stated (406 U.S. at 151) that the proscriptions of the securities laws, "by repeated use of the word 'any' are obviously meant to be inclusive."

Significantly, defendants' brief does not even address itself to, much less explain away, the language of the statutory definition. The words of the statute are clear and on their face include the stock of 1050 Tenants Corp.; no authority has been cited to support defendant's request that the Court simply ignore the statutory language so as to give a strained and restrictive construction to the definitions.

The cases cited by defendants (Br. pp. 22-23) do not hold to the contrary. Rather those decisions merely hold that, in keeping with the public policy of liberal and broad construction which underlies the federal securities laws, the Courts have the power to *expand* the statutory language where appropriate to include schemes which, in actual essence if not in form, involve "securities." As

* This Court affirmed, 452 F.2d 662, but did not reach the issue of whether all notes are securities.

Judge Stewart recognized (365 F. Supp. at 1175), these decisions (*Tcherepnin, Howey, Joiner* and *Mincella*) did *not* involve offerings which fall within the express provisions of the statutory definitions and do *not* stand for the converse proposition asserted by defendants: namely, that the Court should disregard the form used so as to give the definitions restrictive meaning and *exclude* the transactions from the statute.

2. *The use of a corporate structure*

Equally dispositive is the fact that at bar the stock was actually issued by a business corporation, i.e., "within a traditional corporate structure" as Judge Stewart emphasized. The Courts and commentators are virtually unanimous that the use of the corporate form and the actual issuance of stock in the transaction establishes that a "security" has been involved. *Stockton* v. *Lucas,* 482 F.2d 979 (Temp. Emerg. U.S. Ct. App. 1973); 3 Bloomenthal, *Securities and Federal Corporate Law,* §2.24[6] at p. 2-67 (1972); Note, "Cooperative Housing Corporations and the Federal Securities Laws," 71 Colum. L. Rev. 118, 127 (1971); Sobieski, "Securities Regulation in California: Recent Developments," 11 U.C.L.A. L. Rev. 1, 7-8 (1963); Wenig & Schulz, "Government Regulation of the Condominium in California," 14 Hast. L.J. 222, 233 (1963); Anderson, "Cooperative Apartments in Florida: A Legal Analysis," 12 Miami L. Rev. 13, 21 (1957); Note, "Cooperative Apartment Housing," 61 Harv. L. Rev. 1407, 1425 (1948).

Thus, in Note, 71 Colum. L. Rev. 118, *supra,* the Commentator noted (at p. 127, n. 82):

> "The most widely used casebook in the field, R. Jennings & H. Marsh, *Securities Regulation,* 242 (1968) states

that: 'When a stock corporation is used, the securities acts seem literally to apply, even though the profit motive is not dominant.'" (Emphasis supplied.)

Defendants claim (Br., p. 20) that Professor Loss agrees with their view at bar. However, the fact is that Professor Loss has acknowledged in his treatise:

"When the ownership of an individual apartment is evidenced by stock in the cooperative, as it usually is, the federal and state securities statutes would seem literally to apply." I Loss, *Securities Regulation*, 492-93 (1961).

This conclusion can hardly be seriously disputed at bar. 1050 Tenants Corp. is a business corporation, and its stock, like that of any other business corporation, carries with it the same voting and other rights of a typical corporate stockholder.

3. *The applicable federal decisions*

Those federal courts which have been confronted with the same fact situation here presented have all reached the same conclusion, either expressly or implicitly: namely, that where shares of stock are issued by a business corporation, those shares are "securities," notwithstanding the fact that the corporation is a cooperative housing corporation. *Stockton* v. *Lucas*, 482 F.2d 979 (Temp. Emerg. U. S. Ct. App. 1973); *Ashton* v. *Thornley Realty Co.*, 346 F. Supp. 1294 (S.D.N.Y. 1972) aff'd 471 F.2d 647 (2d Cir. 1973). See also: *Davenport* v. *U. S.*, 260 F.2d 591 (9th Cir. 1958) cert. denied 359 U.S. 909 (1959).

In *Stockton* v. *Lucas, supra* (482 F.2d 979), the Court of Appeals held that shares of stock in a cooperative hous-

ing corporation in New York City were "securities," not interests in "real estate," and thus were exempt from the Phase I price controls on real estate. The Court of Appeals, in a detailed and well-reasoned opinion, stated:

> "The trial court held the subject matter of the sale to be real estate. We disagree with such conclusion . . . The characteristics of stock are 'a right to participate proportionately in all profits (if any), and in management, and in the distribution of net assets on liquidation . . .' [citations omitted] . . . The capital is the property of the artificial person, . . . the shares of stock are the property of the several stockholders' [citation omitted]. The fact that the entire capital stock of a corporation is invested in realty does not alter the character of the shares of stock as personalty [citation omitted]. In short, stock is incorporeal personal property representing a capital interest in a corporation. Restrictions on the right to transfer are permitted under New York law and do not alter the characterization of the property as stock [citations omitted]." (482 F.2d at 983)

Judge Pierce's opinion in *Forman* v. *Community Services, Inc.*, 366 F. Supp. 1117 (S.D.N.Y. 1973), appeal argued April 4, 1974 (Dkt. No. 73-2613) is not to the contrary. Both Judge Stewart at bar (365 F. Supp. at 1173) and Judge Pierce in *Forman* (366 F. Supp. at 1127 n. 32 and 1130 n. 42) recognized that the situation there presented, namely a nonprofit public housing corporation* formed

* Indeed, as Judge Pierce emphasized, unlike the situation at bar, the holders of the shares in *Forman* were even prohibited by statute from reselling their shares at a profit (see 366 F. Supp. at 1129).

under the New York Private Housing Law and subject to all-pervasive control and supervision of the Commissioner of the New York State Department of Housing, is materially different from that of a private business corporation such as that at bar. Thus, Judge Stewart stated below (365 F. Supp. at 1173):

> "We point out, however, that the elements of state control and non-profit make that case materially different from the one at bar, as Judge Pierce himself recognized."

The argument by defendants that "the sale of real estate does not involve the sale of securities" is beside the mark. The individual plaintiffs at bar purchased stock, not realty; they are stockholders and tenants, not landholders. See, e.g., *Stockton* v. *Lucas, supra; Susskind* v. *1136 Tenants Corp.*, 43 Misc. 2d 588 (Civ. Ct. N. Y. Co. 1964).

4. *The view of the SEC*

The Securities and Exchange Commission has expressly exempted stock in cooperative housing corporations from the registration requirements of the federal securities laws,* thus creating the clear negative inference that the SEC deems such stock a security or else would not have felt any necessity to exempt it from registration. 3 Bloom-

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* SEC Rule 235(a), 17 C.F.R. §230.235(a), provides with respect to the Securities Act of 1933:

> "*Stock or other securities* representing membership in any cooperative housing corporation shall be exempt from registration under the Act if the terms and conditions of this rule are met . . . " (Emphasis added.)

Similarly, brokers who sell such securities are exempted from the registration provisions of the Securities Exchange Act of 1934 SEC Rule 15a-2, 47 C.F.R. §240 15a-2.

enthal, *Securities and Federal Corporate Law,* §2.24[6] at p. 2-67 (1972); Note, "Cooperative Housing Corporations and the Federal Securities Laws," 71 Colum. L. Rev. 118, 127 (1971). Accord: Report of the Real Estate Advisory Committee to the SEC, 10/12/72, at p. 90 n. 26.*

As the author notes in *Securities and Federal Corporate Law, supra* (at p. 2-67):

> "If the corporate form is involved and stock issued by the corporation, the corporation has issued a security. In recognition of this fact, the [Securities and Exchange] Commission has utilized its authority under Section 3(b) of the Securities Act to exempt from registration securities in cooperative-housing corporations...."

Similarly, in Note, 71 Colum. L. Rev. 118, *supra* (at p. 127), the commentator observed:

> "[I]t does appear that the Securities and Exchange Commission believes such shares to be securities for section 2(1) purposes. Otherwise, the Commission would hardly have exempted certain types of cooperative housing securities from the requirements of Section 5 of the 1933 Act, and exempted licensed real estate brokers who deal in such securities from the broker-dealer requirements of the Exchange Act. The Commission's belief is apparently based on the broad purposes of the securities acts coupled with the formal

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* It is settled, of course, that the fact that a security is exempt from registration under the 1933 Act does not exempt it from the anti-fraud provisions of the federal securities laws. See, e.g., *Hill York Corp.* v. *Amer. Intl. Franchises,* 448 F.2d 680, 695 (5th Cir. 1971); *Baron* v. *Shields,* 131 F. Supp. 370, 372 (S.D.N.Y. 1954); *Moore* v. *Gorman,* 75 F. Supp. 453, 456 (S.D.N.Y. 1948).

resemblance between such shares and the typical corporate security, and this belief is not to be lightly regarded in view of the great weight federal courts have given the administrative construction of the securities laws."

Defendants erroneously claim (Br., p. 20) that the SEC has an "unequivocal position" directly contrary to that observed by these commentators. Defendants cite no authorities in support of this extraordinary contention; instead they merely argue that the SEC does not deem interests in condominiums to be securities and that the Real Estate Advisory Committee to the SEC has suggested that the same rule be applied to cooperatives. Defendants, however, are operating on a faulty premise. Whether or not the Real Estate Advisory Committee did recommend that the SEC change its legal treatment of cooperatives,*

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* At most, the Committee recommended that cooperatives be treated like condominiums. This does not mean, however, that stock in cooperative housing corporations should not be deemed a security. The SEC has drawn distinctions even among condominiums and treats some as issuers of securities. See: Securities Act Release No. 5347, reported at CCH Fed. Sec. L. Rpt. ¶79,163 (1973).

In point of fact, however, sound reasons exist for distinguishing between condominiums and cooperatives. The two are markedly different in nature, as the Court explained in *Susskind* v. *1136 Tenants Corp.*, 43 Misc. 2d 588, 592 (Civ. Ct. N.Y. Co. 1964):

"[A] condominium unit is real property while an ordinary cooperative apartment is classified as personalty . . . Basically, in a condominium, each purchaser, by deed, receives a fee simple in an apartment and an undivided interest in the common areas of the building . . . It is noteworthy that a condominium conveys 'units' by 'recorded deeds' while an ordinary cooperative leases 'apartments' to shareholder lessees by 'proprietary leases' . . . A corporate co-operative thus indicates an entity holding title to all the premises and granting rights of occupancy to particular apartments. The condo-

the SEC did *not* adopt such a change. Rather, the situation remains as the Real Estate Advisory Report specifically conceded (at p. 90, n. 26):

> "Occupancy interests in cooperative housing are currently viewed as 'securities', primarily because such interests are represented by 'stock'.
>
> It was partly in recognition of the fiction of calling cooperative stock 'securities' that Rule 235 under the Securities Act, exempting offerings of securities in a residential cooperative . . . was adopted."

In sum, the SEC appears clearly to support plaintiffs at bar, and certainly has given no indication that it supports defendants as they inexplicably claim in their brief on appeal.

5. *The applicable state cases*

Defendants incorrectly suggest (Br., p. 21) that the pertinent state authority favors them, rather than plaintiffs, at bar. Those states which appear to deal most with housing cooperative corporations—New York, California, Illinois and Florida—all regard the stock of such corporations as a "security."

In New York, defendants were required to file their offering plan (in effect to register their securities) with the Attorney General's office pursuant to General Business Law §352-e which specifically defines "security" to include "stocks".

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minium, on the other hand, refers specifically to schemes of individual ownership of individual apartments organized pursuant to statutory authority [citation omitted]."

As the New York Court of Appeals recently said in *Reiter* v. *Greenberg*, 21 N.Y. 2d 388, 392 (1968):

> "This act [§352-e] reaffirmed existing authority that the sale of limited partnership interests, stocks, bonds and other securities of real estate companies are 'securities' within the purview of the Martin Act [the New York blue sky law] and not real estate."

See also: *Susskind* v. *1136 Tenants Corp.*, 43 Misc. 2d 588 (Civ. Ct. N. Y. Co. 1964).

California agrees. As pointed out by many commentators, following the leading case of *Silver Hills Country Club* v. *Sobieski*, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961), which held that memberships in a country club were "securities," the Attorney General of California specifically ruled that shares in cooperative housing corporations were also "securities" for blue sky purposes. See: Note "Cooperative Housing Corporations and the Federal Securities Laws," 71 Colum. L. Rev. 118, 130 n. 104 (1971); Sobieski, "Security Regulation in California: Recent Developments," 11 U.C.L.A. L. Rev. 1, 7-8 n. 83 (1963); Wenig & Schulz, "Government Regulation of the Condominium in California," 14 Hast. L.J. 222, 223 (1963).

And as the Wenig & Schulz article, *supra*, points out (at p. 233 of 14 Hast. L.J.):

> "Proprietary leasing stock cooperative projects which are sold coupled with shares of stock in the property owning corporation have long been treated as securities..."

Florida agrees. The Florida Securities Commission has stated:

"We respectfully call your attention to page 621 of the Biennial Report of the Attorney General, 1935-1936, wherein an opinion was rendered by this Commission on February 13, 1935, which gives an affirmative answer to the question of whether or not stock involved in a cooperative housing venture must be registered with this Commission, and further, that the salesmen therein must also be registered. You will note the concluding paragraph of this opinion reads:

'I can find no distinction between the sale of this stock and the sale of any other security, within the terms of the Act, which would in any manner take it out of the operation of the broad definitions of "security" and "sale" as given in this Act.'" (Emphasis supplied.)

("Cooperative Housing Ventures," December 28, 1955 quoted in Anderson, "Cooperative Apartments in Florida: A Legal Analysis," 12 Miami L. Rev. 13, 17 n. 18 (1957))

Illinois also agrees. By enacting its Securities Law of 1953, Illinois legislatively reversed the decision of *Brothers* v. *McMahon,* 351 Ill. App. 321, 115 N.E.2d 116 (1953), upon which defendants rely at bar. As explained in Young, "Exemptions From Registration Under Illinois Securities Law," 1961 U. of Ill. L.F. 205, 207 (1961):

"This case [*Brothers* v. *McMahon*] was not decided under the 1953 Law, and the decision of the appellate Court in the same district, in *Sire Plan Portfolios, Inc.* v. *Carpentier* [8 Ill. App. 2d 354, 132 N.E.2d 78 (1st Dist. 1956)] which was decided under the 1953 Law,

> appears to be contrary authority . . . The Office of the Secretary of State of the State of Illinois, which administers the 1953 Law, interprets the term 'securities' to include the sale of 'interests in cooperative apartment projects' . . ."

The state authorities relied upon by defendants (Br., p. 21) are all distinguishable and otherwise not in point. As one commentator has stated as to each of them:

> "The vitality of these particular cases appears minimal. One [*Brothers* v. *McMahon,* 351 Ill. App. 321, 115 N.E. 2d 116 (1953)] is widely regarded as bad law within its own state; another [*State* v. *Silberberg,* 166 Ohio St. 101, 139 N.E.2d 342 (1956)] placed great stress on the fact that the purchaser actually bought land, which was specifically exempt from the state's blue sky law; and the third [*Willmont* v. *Tellone,* 137 So. 2d 610 (Fla. Dist. Ct. App. 1962)] was decided in highly conclusory manner." Note, 71 Colum. L. Rev. 118, *supra,* at 130-31 (1971).

Other distinctions also exist. First, not a single case involved the actual issuance of stock, as at bar. Further, as already noted, the *Brothers* case had been reversed by statute. And in *Willmont,* the Court emphasized (at p. 612 of 137 So. 2d) that, unlike the case at bar, no corporation was ever actually formed and no stock ever issued or sold; thus, no "security" sale was involved either in substance or form.* *State* v. *Hirsch,* 101 Ohio App. 425,

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* This same distinction renders defendants' other case, *Contract Buyers League* v. *F & F Investment,* 300 F. Supp. 210 (N.D. Ill. 1969) inapplicable. That case dealt solely with the sale of private residences by alleged blockbusters. No stock or corporation was even remotely involved.

131 N.E.2d 419 (Ct. App. 1956) is a copy of *State* v. *Silberberg, supra,* and inapplicable for the same reasons noted above with regard to that case.

POINT III

The Transaction at Issue Involved the Sale of "Investment Contracts".

Alternatively, Judge Stewart correctly held that defendants had sold "investment contracts" at bar, and thus the transactions at issue fall within that separate additional category of instruments included in the definition of "security." Applying the three prong test established in *SEC* v. *W. J. Howey Co.,* 328 U.S. 293, 298-99 (1946) and its progeny, Judge Stewart correctly found that (a) there had been a common enterprise; (b) there had been an expectation of profit; and (c) the profits were to have been derived from reliance on third parties.

No question is raised as to the first of these three elements; defendants, however, ask the Court to apply restrictive meaning to the other two elements of "investment contract." The authorities require otherwise.

1. *The expectation of profit*

Judge Stewart correctly held that at least three different forms of "profit" expectation were present at bar.

First, Judge Stewart recognized there was and is a very real possibility of profit on resale of the stock since "there are no provisions, as there were in the *Forman* situation (cf. 366 F. Supp. at 1129), prohibiting transfer of shares at a price higher than the stockholder originally paid"

(365 F. Supp. at 1176). This investment aspect of the transactions at bar, and the realization that the value of cooperative securities is subject to price fluctuations, so that on resale, the stockholders may well incur either a substantial profit or loss on their investment, has sound antecedents in state law. See, e.g., *Abel* v. *Paterno,* 245 App. Div. 285, 289-90 (1st Dept. 1935) rearg. den. 245 App. Div. 812 (1st Dept. 1935), where the Court observed:

> "Respondents contend that the only purpose of owning the stock was the acquiring of the right to occupy a certain, particular apartment . . . at the cost of maintenance thereof; . . . that the stock was put to this use . . . and, therefore, they have no cause of action in fraud or deceit, irrespective of what representation may have been made. Of course, such argument would not be applicable to apartments bought for investment purposes. But, in any event, we cannot agree with the contention. It may be true that in a cooperative apartment enterprise the primary object is occupancy of an apartment, but the purchaser also becomes the owner of stock in a real estate holding corporation . . ."

Secondly, by virtue of their ownership of the stock, the purchasers expected to receive substantial tax benefits, which represent a "direct monetary benefit" to them (365 F. Supp. at 1176). In this regard, as Judge Stewart held, it ill-behooves these defendants, who emphasized this potential monetary gain in their selling prospectus, now to disavow it (*id.*). The SEC apparently agrees. See Securities Act Release No. 5347, CCH Fed. Sec. L. Rep. ¶79,163 at p. 82,539 (1973).

Finally, the corporation rented and received income from doctors' offices and laundry machines at the building, all of which went to offset the maintenance charges otherwise payable by the stockholders.

Judge Stewart accurately described the significance of these earnings (365 F. Supp. at 1176):

> "The space available for professional offices presented the likelihood of income to the Corporation. While this income would not result in dividends to the shareholders, but merely a reduction in their monthly maintenance charges, this is merely a difference in degree, or quantity of profits, rather than a difference in kind." *

Accord: Note, "Cooperative Housing Corporations and the Federal Securities Laws," 71 Colum. L. Rev. 118, 132 (1971). The SEC has also recognized this type of "profit" to be a basis for declaring an interest in a cooperative corporation to be a "security." See: *U of F Students Cooperative, Inc.*, CCH Fed. Sec. L. Rep. ¶78,347 (SEC 1971).

Judge Stewart correctly held that each of these items satisfies the "profit" requirement, regardless of whether the Court were to give a broad or restrictive meaning to the definition of "profit." Note, 71 Colum. L. Rev. 118, *supra*, at 130 and 132.

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* In *State ex rel. Troy* v. *Lumberman's Clinic*, 186 Wash. 384, 58 P.2d 812, 816 (1936), the Court observed:

> "Profit does not necessarily mean a direct return by way of dividends, interest, capital account, or salaries. A saving of expense which would otherwise necessarily be incurred is also a profit to the person benefited."

2. *Reliance on others*

To satisfy the reliance element of the definition of an "investment contract" the investor need not have relied completely upon the efforts of the third-party, but may himself take some role in the management of the venture. See, e.g., *SEC* v. *Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 (9th Cir. 1973) cert. den. —— U.S. —— (1973). The SEC shares this view; indeed, in its Securities Act Release No. 5347, CCH Fed. Sec. L. Rep. ¶79,163 at p. 82,539 (1973), which sets forth suggested guidelines regarding which condominiums involve the sale of securities and which do not, the SEC states:

> "Recent interpretations have indicated that the expected return need not be *solely* from the efforts of others as the holding in *Howey* appears to indicate. For this reason, an investment contract may be present in situations where an investor is not wholly inactive, but even participates to a limited degree in the operations of the business." (Emphasis in original.)

Judge Stewart properly held that this element of the test was also met at bar since the defendant sponsors themselves organized, completely controlled and fixed the operating guidelines for the corporation, since they even had the possibility of partaking in corporate decisions after the closing and since they had committed the corporation to nine continuing contracts, including one for the management of the building by a third party (Pease & Elliman) which extended three years past the closing (365 F. Supp. at 1177). Judge Stewart properly found persuasive the conclusion of the commentator in Note, 71 Colum. L. Rev. 118, *supra* (at pp. 128-29):

"It may be argued that significant reliance on the sponsor is impossible since the corporation is theoretically subject to the shareholders' control which they exercise in the election of the board of directors. However . . . the development stage—the investigation and selection of a site, the sale of fractional interests to investors, and the reliance on the promoter for information—should be the relevant period when considering who is exercising control. Moreover, even in the management stages, most of the important decisions have been conclusively made by the sponsor before the board of directors begins to function and are not subject to change. Such decisions include the allocation of shares, the financing arrangements, long-term commercial leases, and long-term service contracts. Indeed, the actual management is often provided for by a long term management contract, again arranged by the sponsor . . . When one considers all the decisions actually made by the sponsor for the corporation, the board of directors is left only with a small amount of residual power. The necessary conclusion, on the basis of control, is that most cooperative shares are securities" (emphasis supplied).

Defendants have offered no controlling authority to the contrary and no persuasive reason why these facts should be disregarded so as to give a restrictive interpretation to the transaction at bar.

POINT IV

Strong Public Policy Reasons Support the Result Reached Below.

The view of the commentators is virtually unanimous that purchasers of the stock of cooperative housing corporations need the protections of the anti-fraud provisions of the federal securities laws. Existing state controls simply have not succeeded in insuring fair and full disclosure of the financial facts pertinent to an investor's purchase of such stock. Thus, the most recent and definitive law article written on the subject, Note, "Cooperative Housing Corporation and the Federal Securities Laws," 71 Colum. L. Rev. 118 (1971), states (at p. 120):

> "There has been a growth in abuses by developers and promoters. Some of these abuses have been rather extreme."

The author continues (at pp. 120-21) to outline the abuses as follows: (1) retention of unconscionable profit by the promoters; (2) presubscription self-dealing; (3) underestimation of costs which the tenant-shareholder will incur; (4) understatement of the actual cost of physical maintenance; and (5) non-disclosure of such matters as possible increases in real estate tax assessments and the details of the estimates of needed repairs included in the sponsors' prospectus. These are exactly the same types of wrongs complained about at bar (cf. 13a-16a).

As the author further states, a judicial construction that the antifraud provisions of the federal securities acts apply to the securities at bar will materially assist in deterring such misstatements and nondisclosures (at p. 123):

> "[T]he disclosure provisions of the [federal] securities laws seem particularly well suited for curbing the abuses to which these sales are subject."

and (at p. 124):

> "The enforcement apparatus and civil liability provisions presently included in the [federal] securities law offer perhaps their greatest advantage as a means of curbing the abuses to which sales of cooperative shares are subject."

Federal redress has become even more appropriate and necessary* as promoters have increased their interstate solicitation and use of the mails to sell stock in cooperatives in Florida and in "multi-state" cities such as New York and Chicago. Thus, numerous other commentators support and call for the salutary result reached by Judge Stewart. See: Sobieski, "Securities Regulation in California: Recent Developments," 11 U.C.L.A. L. Rev. 1, 7-8 (1963); Wenig & Schulz, "Government Regulation of Condominiums in California," 14 Hast. L. J. 222, 233 (1963); Anderson, "Cooperative Apartments in Florida: A Legal Analysis," 12 Miami L. Rev. 13, 21 (1957); Note, "Cooperative Apartment Housing," 61 Harv. L. Rev. 1407, 1425 (1948).

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* Defendants' repeated references (Br. pp. 16-17, 36) to the Interstate Land Sales Full Disclosure Act, 15 U.S.C. §§1701, et seq., are beside the mark. That statute deals only with the sale of subdivisions of "fifty or more lots" of realty, not apartments or other portions of buildings on a single parcel of realty. Cf. 15 U.S.C. §§1701(a)(3), 1702(a)(1) and (3). Indeed, §1702(a)(3) expressly exempts from that statute "the sale or lease of any improved land on which there is a residential, commercial, or industrial building . . . "; obviously the cooperative plan at bar involved such a transaction.

We respectfully submit that only the result reached by Judge Stewart below—which comports with the plain language of the statutes, the pertinent cases and apparent SEC interpretation—will suffice to insure full and detailed disclosure to unwitting purchasers by those selling stock in housing cooperative corporations such as 1050 Tenants Corp.

CONCLUSION

The order appealed from should be affirmed.

Respectfully submitted,

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Service of ~~three~~ Two (2) copies of the within BRIEF
is admitted this 11th day of April 1914

By [illegible]
Defendants-Appellants